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TAGS: EFIN ECON EINV ENRG PGOV NI
SUBJECT: NIGERIA: CBN TAKES ACTION TO SLOW NAIRA DEVALUATION

REF: A. LAGOS 22
¶B. 08 LAGOS 520
¶B. 08 ABUJA 2387
¶C. 08 ABUJA 2437
¶D. 08 ABUJA 2386
¶E. 08 ABUJA 2365
¶F. 08 LAGOS 465
¶G. 08 ABUJA 2225
¶H. 08 ABUJA 2180
¶I. 08 LAGOS 426
¶J. 08 LAGOS 353
¶K. 08 ABUJA 1599

¶1. (SBU) Summary. The naira has lost over 25% of its value vis-`-vis the dollar since November 26, 2008. It exchanged for 120 naira to one dollar in the official market in November 2008 as against 150 naira to one dollar on January 14, 2009. This is in sharp contrast to the relative stability maintained since 2005. On January 13 2009, Central Bank of Nigeria (CBN) Governor Charles Soludo told the media that the devaluation was a deliberate attempt to bring the naira in line with other major currency depreciations and to avoid Nigeria becoming a dumping ground for imports. The recent volatility in the foreign exchange rate may also have been accentuated by the activity of currency speculators. In order to check naira speculation and ensure that only eligible imports receive foreign exchange, the CBN plans to introduce a Retail Dutch Auction System (RDAS) for foreign exchange sales that requires banks to provide documentation on their customers and the purpose of the transaction. This list of purchasers will be published bi-weekly in the national newspapers. Soludo also asserted that all foreign exchange demand must be cash backed and foreign exchange bought at the Retail Dutch Auction system may not be sold at the interbank market. The RDAS will take place every Monday and Wednesday and will commence on January 19. End Summary.

¶2. (U) The naira's relative stability over the past three years was largely due to high crude oil prices, which provided the opportunity to shore up Nigeria's foreign exchange reserves. Economic reforms, which included banking reforms, implemented since 2003 also led to macroeconomic stability. This stability attracted foreign portfolio investors, and increased foreign credit lines to Nigerian banks that boosted the supply of dollars to the foreign exchange market. The market hitherto had depended only on the CBN to supply all foreign exchange demanded through the Wholesale Dutch Auction System (reftel F). (Comment: The WDAS was introduced by the CBN in July 2002 as part of reforms in the foreign exchange market aimed at narrowing the premium between the official market rate and the parallel market, and ensure that the CBN has a firmer control on the foreign

exchange market. The Dutch Auction System is an auction where bidders pay according to their bid rates while the ruling rate is arrived at with the last bid that clears the market. Under the WDAS, banks were not required to submit documentation containing what their clients would use the foreign exchange for before bidding for foreign exchange. Under the soon to be introduced RDAS full documentation and disclosure will be required. End Comment.)

¶3. (SBU) Better macroeconomic management also resulted in a reduction of the premium between the official foreign exchange rate and the parallel "black market" rate, easily achieved because there were multiple sources of dollar supply. The premium reduction made foreign exchange "round-tripping" by banks unattractive (Comment: Foreign exchange round-tripping is arbitrage trading in foreign exchange by banks by buying at a discount from the official market at the CBN and selling at a premium at the parallel market. Some banks were penalized in 2002/2003 and had their foreign exchange dealing license suspended for a year for engaging in such activities. End Comment).

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Dollars Dry Up

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¶4. (U) Due to access to credit tightening globally, foreign financial institutions have withdrawn credit lines to Nigerian banks, leading to a demand increase for foreign exchange in the interbank foreign exchange market. (Comment: The interbank market is an over-the-counter market for trading in foreign exchange among Nigerian banks. Bank treasury officers conduct the trade. End Comment). In addition, foreign portfolio investors exited the Nigerian capital market because most invested funds were borrowed from foreign financial institutions in their home countries.

Remittances from Nigerians in the diaspora also have dropped. Lastly, crude oil price reductions have limited Nigeria's major foreign exchange earner. All these factors resulted in a constriction in the local foreign exchange supply, while the demand was increasing.

¶5. (U) This situation caused the interbank market to shut down in early December 2008 (reftel E). The CBN has assumed the role of major supplier of foreign exchange to meet increased demand at market determined rates. After the fact, the CBN claims it devalued the naira to bring it into equilibrium with other major currencies that depreciated. The CBN had to withdraw dollars from the foreign exchange reserves to meet demand to stabilize the market.

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Currency Speculators

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¶6. (SBU) Speculators may be using the current situation to bet against the naira by buying dollars in anticipation of a further fall in the naira value. Demand for dollars continued increasing at the start of 2009 with the CBN meeting only a fraction of the demand. The CBN's intervention in the market had led to a reduction in foreign exchange reserves from $59 billion in November 2008 to $53 billion mid-January 2009. The CBN's failure to meet foreign exchange demand and not provide clear policy guidance encouraged further speculation in the foreign exchange market. Also the premium between the official market and parallel market rate widened significantly, thus encouraging currency arbitrage. The official rate was 150 naira to one dollar, while the parallel "black market" rate was 160 naira to one dollar on January 14.

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Banks Caught Speculating Will Be Penalized

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¶7. (SBU) After an emergency Bankers' Committee meeting on January 13, CBN Governor Soludo announced that the CBN deliberately devalued the naira to prevent Nigeria from becoming a dumping ground for imports. He said that the naira had to be brought in equilibrium with other international currencies which had also experienced depreciation in their value. Soludo also asserted that the CBN remains committed to defending the value of the naira and would soon announce a band it wants the naira to trade against the dollar. He

noted the foreign exchange reserve stands at $53 billion and "is healthy and sufficient to meet the demand in the foreign exchange market." He warned that banks caught round-tripping will be severely punished. (Comment: There are unconfirmed reports that some banks have been stockpiling dollars in anticipation of further naira depreciation, to engage in currency arbitrage. This could be true because since the beginning of the global financial crisis Nigerian banks' avenues for profit making have been reduced because the banks shy away from lending, the capital market has crashed, and there is a lull in the real estate market. End Comment).

¶8. (U) Soludo underscored that the naira would appreciate and stabilize at a market determined rate below the current rate. The CBN made good its promise to meet foreign exchange demand during January 13 trading by supplying funds to meet 95% of the demand. Out of about $780 million demanded, CBN sold $752 million at the rate of 150 naira to one dollar.

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Next Steps by CBN

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¶9. (U) On January 14, after a Monetary Policy Committee, Soludo announced new guidelines for foreign exchange trading that will be implemented from January 19. In order to check naira speculation and ensure that only eligible imports receive foreign exchange, the CBN plans to introduce a Retail Dutch Auction System (RDAS) for foreign exchange sales that requires banks to provide documentation on their customers and the purpose of the transaction. This list of purchasers will be published bi-weekly in the national newspapers. Soludo also asserted that all foreign exchange demand must be cash backed and foreign exchange bought at the Retail Dutch Auction system may not be sold at the interbank market, and reduced the Net Open Position of banks from 10% to 5% of shareholders' funds. The RDAS will take place every Monday and Wednesday and will commence on January 19.

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Comment

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¶10. (SBU) The naira devaluation will surely curb imports because importers will require more naira in order to be able to purchase a fixed amount of dollars. It may lead to increased exports since Nigerian goods will be cheaper to purchase; however, Nigerian exporters have higher production costs due to infrastructure bottlenecks such as power, roads and inefficient ports, which cannot be fixed overnight. Also, trade policy, such as prohibiting the importation of packaging materials means that exporters have to use poor quality packaging. Both factors affect the competitiveness of Nigerian products and devaluation may not lead to an increase in exports if the cost of doing business remains high. The Nigerian Manufacturers Association of Nigeria has publicly expressed concerns that the devaluation could raise the cost of importing raw materials. The CBN's ability to manipulate monetary policy will become more limited as foreign exchange reserves are drawn down to meet forex demand. If lower than expected crude oil prices continue and the naira depreciates further, the balance of payments may become a concern. The current situation supports arguments for Nigeria to diversify its revenue base by focusing on other sectors such as agriculture and solid minerals. End Comment.

¶11. (U) This cable was coordinated with ConGen Lagos.

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